



Frank S. Simone
Government Affairs Director

Suite 1000
1120 20th Street, NW
Washington DC 20036
202-457-2321
832-213-0282 FAX
fsimone@att.com

February 26, 2004

VIA ELECTRONIC FILING

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, S. W. – Room TWB-204
Washington, D. C. 20554

Re: *Ex parte*, WC Docket No. 03-228, Section 272(b)(1)'s Operate
Independently Requirement for Section 272 Affiliates

Dear Ms. Dortch:

On Wednesday, February 25, 2004, Aryeh Friedman and the undersigned, representing AT&T, and Richard Klingler of Sidley Austin Brown and Wood, also representing AT&T, met with William Maher, Jeffrey Carlisle and Robert Tanner of the Wireline Competition Bureau and Christi Shewman of the Bureau's Competition Policy Division. The purpose of the meeting was to review the legal framework and analysis underlying AT&T's comments in the above-captioned proceeding and comment on other issues raised by recent *ex parte* submissions. The attached outline summarizes our discussion.

Consistent with Section 1.1206 of the Commission's rules, I am filing one electronic copy of this notice and request that you place it in the record of the above-captioned proceeding.

Sincerely,

A handwritten signature in black ink, appearing to read "F. Simone".

ATTACHMENT

cc: W. Maher
J. Carlisle
R. Tanner
C. Shewman

I. SECTION 272 PRECLUDES ABANDONING THE OI&M SHARING PROHIBITION.

The inquiry required by *Chevron* -- whether Congress has “spoken to the precise question at issue” or precluded an agency determination as unreasonable -- rests on the language, structure, legislative history, and purpose of the statutory provision at issue. *See, e.g., ASCENT v. FCC*, 235 F.3d 62 (D.C. Cir. 2001); *Bell Atlantic Tel. Cos. v. FCC*, 131 F.3d 1044 (D.C. Cir. 1997).

1. Statutory language: “Textual analysis is a language game played on a field known as ‘context,’” *Bell Atlantic*, 131 F.3d at 1047.

- Certain competitive activities of BOCs subject to § 251(c) are to be undertaken through “one or more affiliates that ... are separate from any operating company,” with “[t]he separate affiliate required by this section ... [outlining requirements].” §§ 272(a)(1), (b).
- The separate affiliate “shall operate independently from the Bell operating company.” § 272(b)(1).
- Abandoning the *operating*, installation, and maintenance (“OI&M”) sharing restriction would permit “dependent” (rather than “independent”) and “integrated” (rather than “separate”) “operat[ion]” of the network, the core function that defines the “Bell *operating* company.”
- The context of “separate affiliate” and “operate independently” is the history of regulation of the BOCs’ market power, from the MFJ to the Commission’s various separate affiliate requirements, designed to limit discrimination and cost misallocation – especially as undertaken through control and effective integration of the networks providing competitive and monopoly services.
- The Commission derived the OI&M and joint ownership rules from a plain reading of the “operate independently” requirement and determined that OI&M sharing was precluded by the statutory language.
 - “[O]perational independence’ ... bars a BOC or any BOC affiliate, other than the section 272 affiliate itself, from performing operating, installation, and maintenance functions associated with the facilities that the section 272 affiliate owns or leases” First Report and Order, *Implementation of the Non-Accounting Safeguards of Sections 271 and 272*, 13 FCC Rcd. 11230, ¶ 158 (1996) (subheaded: “Defining ‘Operating Independently’”)
 - Section 272(b)(1) requires determination of whether a BOC is “integrating its local exchange and exchange access operations with its section 272 affiliates activities to such an extent that the affiliate could not reasonably be found to be operating independently, as required by the statute.” *Id.*

- “In these circumstances, our obligation is to interpret the language of section 272(b)(1) in a manner consistent with its purpose, which is to ensure the operational independence of a section 272 affiliate from its affiliated BOC.” *Id.* ¶ 165.
- “[W]ere we to conclude that the BOCs were permitted to provide interLATA services on an integrated basis, it is hard to understand why Congress would choose to require that a separate affiliate ‘operate independently’ of the BOC, or more importantly, why it would choose to require a separate affiliate at all.” Second Order on Reconsideration, *Implementation of the Non-Accounting Safeguards of Sections 271 and 272*, 12 FCC Rcd. 8653, ¶ 47 (1997).
- “[T]he Commission concluded that the “operate independently” language of section 272(b)(1) imposes requirements on section 272 separate affiliates beyond those detailed in sections 272(b)(2)-(5). The Commission’s OI&M rules were adopted to give meaning to the ‘operate independently’ requirement.” Order, *Petition of Verizon for Forbearance from the Prohibition of Sharing Operating, Installation and Maintenance Functions*, CC Docket No. 96-149, ¶ 8 (Nov. 4, 2003)

2. Statutory structure.

- “Operate independently” is an aspect of particular requirements establishing what constitutes a “separate affiliate.” *Compare* § 272(b) with §§ 272(b)(1)-(5).
- “Operate independently” in § 271(b)(1) is one of several particular components of the “separate affiliate” requirement, and distinct meaning must be given to each particular requirement imposed by Congress.
 - §§ 271(b)(2)-(5) could exhaust the separate affiliate requirements only if those provisions were elaborating “operate independently” (rather than “separate affiliate”) or if § 272(b)(1) had been omitted.
 - In the *Non-Accounting Safeguards Order* (¶ 156), the Commission reached a similar conclusion that Congress must have intended § 272(b)(1) to impose separate and distinct requirements by structuring § 272(b)(1) as a separate provision.
- § 272(b)(1)’s additional purposes (apart from independent operation), related to preventing monopolists’ discriminatory conduct and cost misallocation, are confirmed by that provision’s inclusion among § 272’s other provisions addressing these risks. *See* §§ 272(a)(1), 272(b)(2)-(5), 272(c)-(e).
- The statute’s preclusion of the Commission from forbearing from applying the § 272(b)(1) requirements confirms that the statute precludes the Commission from reaching the same result through a statutory construction at odds with the section’s text and structure.

- See *ASCENT v. FCC*, 235 F.3d at 666-68.
- Dissenting Statement of Commissioner Abernathy, *Petition of Verizon for Forbearance from the Prohibition of Sharing Operating, Installation, and Maintenance Functions*, FCC 03-271 (Nov. 4, 2003) (“I find it anomalous, to say the least, that at the same time the Commission finds the OI&M rule to be a requirement of the statute, it is willing to adopt a companion NPRM that expresses a willingness to consider elimination of this very rule. If the majority is correct that the OI&M rule is a requirement of the Communications Act, then how can we simultaneously propose to do away with it in a rulemaking?”).

3. Legislative purpose and history.

- The legislative history of §§ 271-72 confirms that separate affiliate requirements were directed to preventing the anticompetitive harms that the MFJ (and the Commission’s separate affiliate requirements) were designed to eliminate: abuse of market power manifested in discrimination, especially through manipulation of control over the network, and cost misallocation. As shown in that legislative history, Congress embraced both the theory that BOC market power manifested itself in discriminatory network abuses and misallocation of costs, as well as the need for a barrier to integrated network operation.
 - Discriminatory operation of the network to disadvantage non-affiliated IXC’s -- through anticompetitive, integrated operation, installation and maintenance, as well as design -- was a principal component of the DOJ’s case against the Bell System and, in that context, was viewed as so severe an anticompetitive risk as to require complete divestiture of the entity providing interexchange services. The § 272 restrictions (upon satisfaction of § 271) were viewed as a relaxation of complete separation but addressed the same risks.
 - Compare SBC Brief in *ASCENT v. FCC*, No. 99-1441 (market power abuse rationale led to § 272’s restrictions and SBC/Ameritech merger conditions).
- Congress can be presumed to legislate, and to use the term “separate affiliate,” against the backdrop of the Commission’s pre-1996 separate affiliate requirements and orders.
- The Commission has eloquently summarized and embraced this understanding of the purposes of the 1996 Act and § 272 in particular.
 - “[A] bar on the integration of a BOC’s local facilities and the additional BOC facilities necessary to provide competitive services such as interLATA services has always been understood by courts and agencies, and the lawyers and economists arguing before them, as the *sine qua non* of a separate affiliate requirement, and we presume that Congress chose to impose a separate affiliate requirement in section 272 with that long-held common understanding in mind.” Second Order on Reconsideration, *Implementation of the Non-Accounting Safeguards in Sections 271 and 272*, 12 FCC Rcd. 8653, ¶ 50 (1997).

- *See id.* ¶¶ 47-49 (extensive discussion of risks of anticompetitive abuse of BOC local facilities, especially discrimination and cost misallocation, requiring separation between competitive and monopoly facilities and their operation, as the basis for Congress' drafting of § 272).

4. RBOC Statutory Construction Arguments.

- Qwest and SBC claim that the requirements of §§ 272(b)(2)-(5) adequately define what Congress required of a “separate affiliate.”
 - Congress is presumed to convey meaning through statutory terms, but the RBOCs' arguments would render § 272(b)(1) a nullity.
 - “[O]perate independently” particularly cannot be a nullity when applied to issues of the integrated “operation” of key network components which historically served as the mechanism for monopoly abuses.
- Qwest claims that, in common business usage, companies outsource many inputs without being thought “dependent” on their supplier or other than “independent.”
 - Qwest's argument entirely ignores that context of the “operate independently” requirement: implementation of the well-understood and longstanding separate affiliate requirement as applied to a monopolist that fully owns a competitor of companies dependent on the monopolist's facilities and service.
 - Qwest's argument provides no meaning to § 272(b)(1).
 - Qwest's argument fails on its own non-contextual terms. A company that outsources an important input is, in common business understanding, “dependent” on the supplier of that service. And if the supplier owned or controlled the company to which it provided service, that subsidiary would not, in common business understanding, be said to be “operating independently” to provide the service resulting from that input.

II. "BALANCING" POLICY CONCERNS CANNOT JUSTIFY ABANDONING THE OI&M SHARING PROHIBITION

- The RBOCs argue and the NPRM suggests that the OI&M prohibition can be resolved by a simple balancing of policy concerns related to the costs and benefits of the prohibition, unrelated to the Congressional judgment of costs and benefits underlying § 271 itself.
 - "Therefore, we seek comment on whether the potential savings to be gained by BOC operations and the potential for increased interLATA competition outweighs any benefits from continuing to apply the OI&M sharing prohibition." Notice of Proposed Rulemaking, *Section 272(b)(1)'s "Operate Independently" Requirement for Section 272 Affiliates*, FCC 03-272, ¶ 9 (Nov. 4, 2003); *id.* at ¶ 7 ("We seek comment on whether the cost data suggest that the costs of the OI&M sharing prohibition outweigh the benefits.").
- The *Chevron* inquiry is designed to determine whether the agency has any discretion to resolve an issue through policy determinations (step 1) and, if so, the permissible scope of what may be determined by policy determinations rather than limited by Congressional determinations (step 2).
 - "[S]tep two inquiry depends on the nature and extent of the ambiguity identified in step 1." *Bell Atlantic*, 131 F.3d at 1049 (quotation omitted)
- Here, whether the OI&M issue is resolved as a *Chevron* step 1 or step 2 determination, it is clear that Congress precluded an interpretation that would have a separate affiliate "operate independently" when the controlling monopolist "operated" the affiliate's network (or provided other service amounting to operation or control).
 - The Commission in evaluating the "costs" of the OI&M prohibition, and thus of the "operate independently" requirement, is purporting to evaluate as a "policy" concern a matter that Congress has already resolved.
 - That is, there is no "ambiguity" committed to the agency that permits negation of the "operate independently" requirement – either by deeming it a nullity or by concluding that the "costs" of independent operation outweigh the benefits.

III. THE COMMISSION'S PRIOR DETERMINATIONS FURTHER CONSTRAIN THE COMMISSION'S ABILITY TO ABANDON THE OI&M PROHIBITION.

- As a general matter, an agency can revisit and rebalance policy determinations as long as it (i) acts within the Congressional grant of delegation created by statutory ambiguity and (ii) clearly explains and justifies the basis for departing from prior determinations. *See, e.g., Motor Vehicles Manuf. Ass'n v. State Farm Mutual Automobile Ins. Co.*, 463 U.S. 29 (1983).
- As canvassed above, the Commission has already essentially concluded that the statute requires the OI&M and joint ownership prohibitions.
 - The *NPRM* (at ¶ 4) notes that the *Non-Accounting Safeguards Order* recognized that cost/benefit analysis could require the Commission to forgo certain restrictions and suggested that such “balancing” could extend to the OI&M sharing prohibition. This is an overreading of the *Non-Accounting Safeguards Order*. In the cited paragraph and in the next paragraph (¶¶ 167-68), the Commission acknowledged “the inherent tension between the ‘operate independently’ requirement and allowing integration of services” and applied the balancing test only to permit certain sharing that “we read section 272(b)(1) not to preclude” – as opposed to the OI&M sharing and joint ownership prohibitions which the Commission had just found to lie at the core of § 272(b)(1)'s requirement.
- The Commission has a long history of acting on the basis that a BOC's ability and incentive to abuse its market power requires rigorous structural separation requirements, and has otherwise embraced the theory and practical observations leading to the OI&M sharing prohibition.
 - *See Computer II and BOC Separations Orders* (addressed in Ex parte of AT&T Corp., *Verizon Petition for Forbearance from the Prohibition on Sharing Operating, Installation, and Maintenance Functions*, at 5-8, CC Docket No. 96-149 (July 9, 2003)).
- The Commission would find it exceptionally difficult to reconcile these prior determinations with an order that (i) resolved the OI&M issue as a matter of cost/benefit analysis or (ii) determined that the separate affiliate could “operate independently” while having its parent operate and otherwise control its network
- Even if evidence could displace Congress's judgment of the purpose of § 272, the Commission's prior determinations would require definitive evidentiary support for concluding that discrimination and cost misallocation risks do not require the OI&M and joint ownership bars.

IV. Other Issues Raised by Recent BOC *Ex Parte* Submissions**1. Prevailing Price Loophole**

- Qwest and SBC argue that the Commission should not be concerned about this loophole because they “normally” or “generally” use fully distributed cost to price their products and services.¹ Verizon states that its OI&M cost savings analysis in the *Verizon OI&M Forbearance proceeding*² assumed that the local exchange carrier would charge its section 272 affiliate at least fully distributed cost for these services,” and that the claimed cost savings “was the difference between the fully loaded labor costs” of the BOC and the section 272 affiliate contractors.³
 - First, as shown in the Selwyn Declaration appended to AT&T’s Comments in this proceeding, “fully distributed cost” does not “embrace or reflect the ‘arms length’ requirement of Section 272(b)(5)” and allows for cost misallocation.⁴
 - Second, BellSouth did not claim it would price at fully distributed, or fully loaded labor, costs, and indeed its representations to the auditor in the section 272 biennial audit,⁵ indicates it would not and could not, do so. In that audit, the auditor reported that 21 agreements did not contain the required disclosure of whether the hourly rate is a fully loaded rate, and whether or not that rate includes the cost of materials and all direct or indirect miscellaneous and overhead costs for goods and services provided at FDC.”⁶ BellSouth represented that these services are subject to the prevailing price rule and “*are provided by BST, the BOC, to BSLD without regard to consideration of Fully Distributed Cost (FDC) ... FDC elements such as materials, full loading and overhead whether direct or indirect are not tracked for these services...*” (emphasis added).⁷
 - Nothing the other BOCs have said in their *ex partes* would preclude them from pricing precisely as BellSouth has. Qwest and SBC refer only to their “general” or “normal” past practices.⁸ Verizon, in its OI&M Forbearance Proceeding filings actually represented that the FDC price its section 272

¹ *Ex parte* Letter from Melissa E. Newman, Qwest, to Marlene Dortch, FCC, Operate Independently NPRM (Feb. 4, 2004) (“Qwest’s Feb. 4, 2004 *ex parte*”) at 3, n.8 and *Ex parte* Letter from Brett A. Kissel, SBC, to Marlene Dortch, FCC, Operate Independently NPRM (Jan. 21, 2004) (“SBC’s Jan. 21, 2004 *ex parte*”) at 1.

² *Verizon Petition for Forbearance from the Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) of the Commission’s Rules*, CC Docket No. 96-149.

³ *Ex parte* Letter from Dee May, Verizon, to Marlene Dortch, FCC, Operate Independently NPRM (January 23, 2004) (“Verizon’s January 23, 2004 *ex parte*”) at 1-2.

⁴ AT&T’s Comments, Operate Independently NPRM, Selwyn Decl. (Dec. 10, 2003) ¶¶ 16-17.

⁵ Report of PricewaterhouseCoopers LLP filed on November 10, 2003 in EB 03-197.

⁶ Objective V/VI, Procedure 5, Appendix A, page 19. The agreements affected include the Network Maintenance Center & Network Management Center Agreement the Facility Use Agreement, End-to-End Test Agreement and InterLATA End-to-End Test Agreement, all of which could be relevant for compliance with the Section 272(b)(1) safeguards.

⁷ *Id.* at 20.

⁸ Qwest’s Feb. 4, 2004 *ex parte* at 3-4.

Section 272(b)(1)'s Operate Independently Requirement for Section 272 Affiliates

affiliate would pay the BOC “reflected the *incremental cost* that the BOCs incur to provide OI&M services to a section 272 affiliate [that] will be charged to that affiliate.”⁹

- Contrary to Verizon’s assertion,¹⁰ the BOCs do structure lower priced affiliate transactions such that, as a practical matter, only the BOC section 272 affiliate is capable of using the service or qualifying for the lowest price. In addition to the Verizon and SBC billing and collection agreements described in the *OI&M Forbearance Proceedings*,¹¹ others have been identified in the audits, *see e.g.*, BellSouth section 272 biennial audit, Objective XI, Procedure 2, Appendix A, page 61, describing its Wholesale National Directory Assistance service sold to BSLD but not unaffiliated carriers.

2. Lack of Cost Substantiation

- AT&T’s January 29, 2004 *ex parte* letter sets forth the documentation the BOCs’ needed to, but did not, provide to substantiate their cost claims. Substantiation is especially important because of the irreconcilable difference in cost savings claims between Verizon and SBC, each claiming hundreds of millions of dollars on the one hand, and BellSouth which, in its most recent filing, claims no more than \$1.9 million.¹²
- The Bureau in other cases has imposed a very high substantiation requirement, *see* Order on Remand, *Verizon 271 Proceeding*, CC Docket No. 01-9, (rel. Feb. 20, 2004) ¶ 12 (summarizing evidence submitted by AT&T) and ¶ 14 (setting forth the additional evidence Bureau held should have been submitted).

⁹ *Ex parte* Letter from Dee May, Verizon, to Marlene Dortch, FCC, *Verizon OI&M Forbearance Proceeding* (August 11, 2003) at 3 (emphasis added), *see also*, Howard Supplemental Declaration appended thereto, ¶ 5.

¹⁰ Verizon’s January 23, 2004 *ex parte* at 3

¹¹ *Ex parte* Letter from Aryeh Friedman, AT&T, to Marlene Dortch, FCC, *Verizon OI&M Forbearance Proceeding* (October 1, 2003) at 5-6; *Ex parte* Letter from Aryeh Friedman, AT&T, to Marlene Dortch, *Petition of SBC for Forbearance from the Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) and 52.203(a)(3) of the Commission’s Rules and Modification of Operating, Installation and Maintenance Conditions Contained In the SBC/Ameritech Merger Order*, CC Docket No. 96-149, 98-141 (October 27, 2003) at 8.

¹² *Ex Parte* Letter from Mary L. Henze, BellSouth, to Marlene Dortch, FCC, Operate Independently NPRM (Feb. 3, 2004) at 1. *See Ameritech-SBC Merger Order* ¶ 106 (“For regulators and competitors, comparative analyses of the practices and approaches of a variety of similarly situated incumbent LECs can render valuable information regarding network features, capabilities and costs”); *Bell Atlantic – GTE Merger Order* ¶ 133.

3. BOC Success Under the Safeguards in All Long Distance Markets

- The BOC statements to the Commission, *e.g.*, SBC's assertions in its February 3, 2004 *ex parte* submission,¹³ regarding the claimed impact of the section 272 safeguards on the "Data marketplace" contrasts sharply with what the BOCs are telling investors.
 - **SBC:** Told investors on November 13, 2003 that the enterprise business segment was "really a sweet spot for SBC and reflects our capabilities and infrastructure today" and that SBC has been very successful in this segment, especially in Frame and ATM. SBC provided specific examples: "we recently closed a \$350 million, 5 year contract for a nationwide frame-relay network ... [a]nother example: a \$9 million, 3 year contract ... [that] requires a 580 site frame relay network. Two more: a \$10 million, 3 year contract ... includes a 221 site frame relay network ... [a]nd finally, we closed a \$10 million contract which includes a 104 site frame relay network."¹⁴
 - **Verizon:** Told investors on January 29, 2004 that its Enterprise voice business showed "[s]trong growth in in-region share - from 32.8% to 34.2%" and that for Enterprise data: "[m]arket share continues to grow both in region & nationally" including "fast packet expansion".¹⁵ Verizon told investors that it had entered into "[n]early 1,200 contracts with large businesses for Enterprise Advance services," and that with respect to "winning customers in markets ... such as ... sophisticated data services to large businesses ... Verizon has a unique leadership role to play in the new broadband and wireless era of communications."¹⁶

¹³ Three separate but identical *ex parte* letters from Brett A. Kissel, SBC, to Marlene Dortch, FCC, Operate Independently NPRM (Feb. 3, 2004).

¹⁴ CCBNStreetEvents, Event Transcript, SBC Communications Analyst Meeting, November 13, 2003, 1:30PM ET, submitted in the Kansas and Oklahoma Petition Proceeding, with AT&T's Reply Comments, WC Docket No. 02-112, filed December 29, 2003, Attachment 7

¹⁵ <http://investor.verizon.com/news/20040129/20040129-4.pdf> (Lawrence T. Babbio Jr. presentation), submitted with AT&T's Massachusetts Section 272 Extension Petition, filed February 19, 2004 at 13, *see also* at 6 (Verizon has 61% consumer LD line penetration of Verizon's switched access lines, 52% in Massachusetts).

¹⁶ <http://investor.verizon.com/financial/quarterly/VZ/4Q2003/4Q03Bulletin.pdf> (Verizon Investor Quarterly) at 2.